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FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 362

Guidance on Due Diligence Requirements for Savings Associations in Determining Whether a Corporate Debt Security is Eligible for Investment

AGENCY: Federal Deposit Insurance Corporation

ACTION: Final guidance.

SUMMARY: On December 15, 2011, the FDIC proposed guidance to assist savings associations in conducting due diligence to determine whether a corporate debt security is eligible for investment under the Proposed Rule. Today, the FDIC is finalizing the guidance. The final guidance document includes clarifying language adopted in the final rule, but otherwise, is being finalized as proposed.

EFFECTIVE DATE: This guidance is effective July 21, 2012.

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SUPPLEMENTARY INFORMATION:

Background

Effective on July 21, 2012, section 939(a) (“section 939(a)”) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) amends section 28(d) (“section 28(d)”) of the Federal Deposit Insurance Act (“FDI Act”) to prohibit a savings association from acquiring or retaining a corporate debt security that does not satisfy creditworthiness standards

established by the Federal Deposit Insurance Corporation (“FDIC”). On December 15, 2011, the FDIC published for public comment a proposed rule (“Proposed Rule” or “NPR”) to implement the requirements of section 939(a). Under the Proposed Rule, an insured savings association would be prohibited from acquiring or retaining a corporate debt security unless it determines, prior to acquiring the security and periodically thereafter, that the issuer has adequate capacity to satisfy all financial commitments under the security for the projected life of the investment. The final rule clarifies the proposed creditworthiness standard; in the final rule, the phrase “the projected life of the investment” has been revised to “the projected life of the security” to more closely track the language in the Office of the Comptroller of the Currency’s (OCC) final rule. Today, the final rule is being published in the Federal Register.

Under Section 28(d) of the FDI Act, federal and state savings associations generally are prohibited from acquiring or retaining, either directly or indirectly through a subsidiary, a corporate debt security that is rated below investment grade. Section 939(a) amends Section 28(d) by replacing the investment-grade standard with a requirement that any corporate debt security investment by a savings association satisfy standards of creditworthiness established by the FDIC. This amendment is effective for all savings associations on July 21, 2012.

On December 15, 2011, the FDIC issued the proposed guidance document together with the Proposed Rule, to seek comment on the FDIC’s proposed implementation of Section 939(a). Specifically, the NPR proposed to amend section 362.11(b) of the FDIC’s regulations to prohibit an insured savings association from acquiring or retaining a corporate debt security unless it determines, prior to acquisition and periodically thereafter, that the issuer has adequate capacity to satisfy all financial commitments under the security for the projected life of the investment. For purposes of the NPR, an issuer would satisfy this requirement if, based on the assessment of

the savings association, the issuer presents a low risk of default and is likely to make full and timely repayment of principal and interest. The proposed guidance document sets forth the criteria a savings association should expect to consider in making such a determination.

The FDIC received five comments on the proposed rule and guidance document from bank trade groups, a bank, and an individual. The commenters generally supported the Proposed Rule and stated that it presented a workable alternative to the use of credit ratings.

Some commenters stated that the “one-size fits-all” due diligence requirements would create an undue burden for smaller savings associations. The FDIC believes that the proposed standard of creditworthiness and the due diligence required to meet it are consistent with those under prior ratings-based standards and existing due diligence requirements and guidance. Even under the prior ratings-based standards, savings associations of all sizes should not rely solely on a credit rating to evaluate the credit risk of a security, and consistently have been advised through guidance and other supervisory materials to supplement any use of credit ratings with additional research on the credit risk of a particular security. Savings associations, regardless of size, should not purchase securities for which they do not understand the relevant risks.

After considering the comments and the issues raised, the FDIC has decided to finalize the guidance with the clarifying revisions adopted in the final rule, but otherwise as proposed. Elsewhere in today’s Federal Register, the FDIC also has published a final rule to amend the FDIC’s regulations in accordance with the requirements of Section 28(d). Both the final rule and final guidance document are effective as of July 21, 2012. The final rule provides for a transition period until January 1, 2013 to provide savings associations time to come into compliance with the final rule and guidance.

Final Guidance

The final guidance document provides supervisory expectations for savings associations conducting due diligence to determine whether a corporate debt securities investment satisfies the creditworthiness requirements of the final rule – that is, whether the issuer has adequate capacity to satisfy all financial commitments under the security for the projected life of the security. The FDIC expects savings associations to conduct appropriate ongoing reviews of their corporate debt investment portfolios to ensure that the composition of the portfolio is consistent with safety and soundness principles and appropriate for the risk profile of the institution as well as the size and complexity of the portfolio.

Text of Final Guidance

The text of the final supervisory guidance regarding the FDIC’s expectations for insured savings associations conducting due diligence to assess the credit risk of a corporate debt security, in accordance with the requirements of 12 CFR 362.11(b), follows.

Purpose

The Federal Deposit Insurance Corporation (“FDIC”) is issuing this guidance document (“Guidance”) to establish supervisory expectations for savings associations conducting due diligence to determine whether a corporate debt security is eligible for investment under 12 CFR part 362. Section 362.11(b) of the FDIC’s regulations implements Section 28(d) of the FDI Act (as amended by section 939(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act), and prohibits an insured savings association from acquiring or retaining a corporate debt security unless it determines, prior to acquiring the security and periodically thereafter, that the issuer has adequate capacity to satisfy all financial commitments under the security for the projected life of the security. An issuer satisfies this requirement if, based on the assessment of the savings association, the issuer presents a low risk of default and is likely to make full and

timely repayment of principal and interest. The investment also must be consistent with safe and sound banking practices.

Background

Part 362 of the FDIC's regulations sets forth the requirements for determining whether securities have appropriate credit quality and marketability characteristics to be purchased and held by insured savings associations. Under section 362.11(b), a savings association may acquire or retain a corporate debt security only if the issuer has adequate capacity to satisfy all financial commitments under the security for the projected life of the security. An issuer satisfies this requirement if, based on the assessment of the savings association, the issuer presents a low risk of default and is likely to make full and timely repayment of principal and interest.

Savings associations must be able to demonstrate that their investment securities meet applicable credit quality standards. This Guidance sets forth criteria that savings associations should consider when conducting due diligence to determine whether a security is eligible for investment under part 362.

The federal banking agencies have maintained long-standing supervisory guidance that banks and savings associations implement a risk management process to ensure that credit risk, including the credit risk of an investment portfolio, is effectively identified, measured, monitored, and controlled. The 1998 *Interagency Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities* (Policy Statement) provides risk management standards for the securities investment activities of banks and savings associations.¹ The Policy

¹ On April 23, 1998, the FDIC, together with the Federal Reserve Board, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision, issued the "[Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities](#)." As issued by the OTS, the Policy Statement applied to both state and Federal savings associations.

Statement emphasizes the importance of an institution conducting a thorough credit risk analysis before and periodically after the acquisition of a security. Such analysis would allow an institution to understand and effectively manage the risks within its investment portfolio, including credit risk, and is an essential element of a sound investment portfolio risk management framework. The Policy Statement is generally consistent with the agencies' *Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts*, which describes the importance of management's credit risk analysis and its use in examiner decisions concerning investment security risk ratings and classifications.²

Determining Whether Securities Are Permissible Prior to Purchase

The FDIC expects savings associations to conduct an appropriate level of due diligence in determining whether a corporate debt security is eligible for investment under 12 CFR 362.11(b). This may include consideration of internal analyses, third-party research and analytics including internal risk ratings, external credit ratings, default statistics, and other sources of information appropriate for the particular security. The depth of the due diligence should be a function of the security's credit quality, the complexity of the issuer's financial structure, and the size of the investment. As an issuer's financial structure becomes more complex, the more credit-related due diligence an institution should perform, even when the credit quality is perceived to be very high. Management should ensure they understand the security's structure and how the security will perform in various scenarios throughout the business cycle. The FDIC expects savings associations to consider a variety of factors relevant to the particular security when determining whether a security is a permissible and sound investment. The range and type of specific factors an institution should consider will vary depending on the particular type and nature of the security. As a general matter, a savings

² See, FDIC Financial Institution Letter, 70-2004 (June 15, 2004).

association will have a greater burden to support its determination if one factor is contradicted by a finding under another factor.

Although part 362 does not provide specific investment quality requirements, savings associations should conduct an appropriate level of due diligence prior to purchasing a corporate debt security to ensure that it is eligible for investment under part 362. A savings association should review and update this analysis periodically, as appropriate for the size and risk profile of the security. By way of example, appropriate factors a savings association should consider include, but should not be limited to, the following:

- Confirm spread to U.S. Treasuries is consistent with bonds of similar credit quality;
- Confirm risk of default is low and consistent with bonds of similar credit quality;
- Confirm capacity to pay through internal credit analysis that can be supplemented with other third-party analytics;
- Understand applicable market demographics/economics; and
- Understand current levels and trends in operating margins, operating efficiency, profitability, return on assets and return on equity.

Maintaining an Appropriate and Effective Portfolio Risk Management Framework

Savings associations should have in place an appropriate risk management framework for the level of risk in their corporate debt investment portfolios. Failure to maintain an adequate investment portfolio risk management process, which includes understanding key portfolio risks, is considered an unsafe and unsound practice. Savings associations should conform to safe and sound banking practices and, similarly, should consider appropriate investment portfolio risks in connection with the acquisition of a corporate debt security.³

³ See supra footnote 1.

Having a strong and robust risk management framework appropriate for the level of risk of a savings association's investment portfolio is particularly critical for managing portfolio credit risk. A key role for management in the oversight process is to translate the risk tolerance levels established by the board of directors into a set of internal operating policies and procedures that govern the institution's investment activities. Specifically, investment policies should provide credit risk concentration limits. Such limits may apply to concentrations relating to a single or related issuer, a geographical area, and obligations with similar characteristics. Savings associations with investment portfolios that lack diversification in one of the aforementioned areas should enhance their monitoring and reporting systems. Safety and soundness principles warrant effective concentration risk management programs to ensure that credit exposures do not reach an excessive level.

Savings associations should identify and measure the risks of their investments periodically after acquisition. Such analyses allow an institution to understand and effectively manage the risks of its investment portfolio, including credit risk, and are an essential element of a sound investment portfolio risk management framework. Exposure to each type of risk for each security should be measured and aggregated with similar exposures on an institution-wide basis. Risk measurement should be obtained from sources independent of sellers or counterparties and should be periodically validated. Irrespective of any contractual or other arrangements, savings associations are responsible for understanding and managing the risks of all of their investments.

By order of the Board of Directors.

Dated at Washington, DC this 18th day of July, 2012.

Federal Deposit Insurance Corporation

Robert E. Feldman,

Executive Secretary

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